Supreme Court, U.S.
FILED
FEB 24 2015
OFFICE OF THE CLERK

Nos. 13-1421, 14-163

In the Supreme Court of the United States

BANK OF AMERICA, N.A.,

Petitioner,

v.

DAVID B. CAULKETT,

Respondent.

BANK OF AMERICA, N.A.,

Petitioner,

v.

EDELMIRO TOLEDO-CARDONA,

Respondent.

On Writ of Certiorari to the United States Court of Appeals for the Eleventh Circuit

BRIEF OF JEROME N. FRANK LEGAL SERVICES ORGANIZATION AND CONNECTICUT FAIR HOUSING CENTER AS AMICI CURIAE IN SUPPORT OF RESPONDENTS

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INTEREST OF AMICI CURIAE[1]

The Jerome N. Frank Legal Services Organization at the Yale Law School ("LSO") is a legal clinic in which law students, supervised by faculty attorneys, provide legal assistance to individuals who cannot afford private counsel. The Mortgage Foreclosure Litigation Clinic (the "Clinic"), part of LSO, has been representing homeowners fighting foreclosure in Connecticut since 2008. In that capacity, the Clinic has appeared in state and federal court proceedings at both the trial and appellate levels, and filed amici briefs with appellate courts in North Carolina, California, and Maine. LSO and its clients also have testified before the Connecticut legislature on foreclosure policy. The students of the LSO are the primary authors of this brief. This brief does not reflect the views of the Yale Law School.

The Connecticut Fair Housing Center ("CFHC") is a nonprofit law office based in Hartford, Connecticut. The Center represents dozens of homeowners in state and federal court, provides individualized advice and in-person foreclosure-related guidance to more than 1800 homeowners each year, and trains and advises hundreds of attorneys, housing counselors, and government employees who work with homeowners facing foreclosure. In addition, the Center works with Congress and the Executive Branch,

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[1] Pursuant to Supreme Court Rule 37.6, this brief was not authored, in whole or in part, by counsel for a party. No person other than the amici and their counsel made a monetary contribution intended to fund the preparation or submission of this brief. All parties have consented to the filing of this brief.

along with all three branches of Connecticut's government, to devise and implement policies that ameliorate the foreclosure crisis and reduce problematic mortgage lending and servicing practices.

CFHC and LSO have an interest in this case because the treatment of junior mortgages in bankruptcy has a crucial impact on outcomes for troubled borrowers and on the health of the housing market overall. Through our organizations' work with homeowners confronting foreclosure, we have been able to observe the distinct role of junior mortgages. We have witnessed the unique challenges junior mortgages create for lenders and borrowers who wish to restructure a purchase-money residential mortgage, as well as for industry and governmental stakeholders that bear the burden of unnecessary foreclosures.

SUMMARY OF ARGUMENT

The Bankruptcy Code reflects two general purposes. First, it seeks to provide debtors with a fresh start. Second, it seeks to preserve assets and efficiently resolve debts for the benefit of creditors and society as a whole. The Bankruptcy Code thereby helps maintain a healthy housing market.

Allowing fully underwater junior mortgages to escape the Section 506(d) lien-voiding provision undermines these essential purposes. Because junior mortgages do not promote a healthy housing market, they do not merit special protections in bankruptcy. Recognizing these concerns, both federal and state programs treated junior mortgages significantly worse than first mortgages in their responses to the unhealthy housing markets of the mid-2000s.

When a second mortgage is entirely underwater, the second mortgagee, by definition, has no legitimate economic stake in the debtor's home. Holders of underwater junior mortgages have incentives to engage in inefficient behavior to extract undeserved side-payments. In doing so, junior mortgagees exhibit the hold-up behavior that bankruptcy seeks to combat.

Allowing lien voiding of fully underwater junior mortgages will not open the floodgates to mass bankruptcy filings because bankruptcy imposes long-lasting costs on the debtor. Nor would allowing such voiding hurt the housing markets. To the contrary, voiding underwater junior liens provides benefits to homeowners, first mortgagees, the housing market, and society as a whole.

ARGUMENT

I. The Role Of Junior Mortgages In The Housing Market Justifies Voiding Junior Liens In Bankruptcy

A. Generally, The Bankruptcy Code Helps Maintain A Healthy Housing Market

Congress's policy goal of maintaining a healthy economy animates the general purposes of the Bankruptcy Code. These general purposes are twofold. First, bankruptcy offers debtors the possibility of a "fresh start." *See, e.g.*, *Local Loan Co. v. Hunt*, 292 U.S. 234, 244 (1934) (quoting *Williams v. U.S. Fid. & Guar. Co.*, 236 U.S. 549, 554-55 (1915)) ("One of the primary purposes of the Bankruptcy Act is to 'relieve the honest debtor from the weight of oppressive indebtedness, and permit him to start afresh '"). To that effect, a number of provisions in the Bankruptcy Code allow a debtor to discharge certain debts and void certain liens. The most important such provision for this case is Section 506(d), which voids a lien "[t]o the extent that [it] secures a claim against the debtor that is not an allowed secured claim." 11 U.S.C. § 506(d).

Second, bankruptcy preserves assets and allocates them efficiently for the benefit of all creditors. *See, e.g.*, *Corporate Assets, Inc. v. Paloian*, 368 F.3d 761, 767 (7th Cir. 2004) ("A central purpose of bankruptcy is to maximize creditor recovery."). To do so, bankruptcy prevents any one creditor from acting unilaterally to obstruct an efficient resolution of debts. The Bankruptcy Code thereby mitigates collective action problems among creditors that would otherwise result in distortive, inefficient behavior by

certain creditors at the expense of other creditors and society as a whole.

By giving debtors a fresh start while efficiently allocating assets to creditors, the Bankruptcy Code helps restore a market to health. Every provision in the Bankruptcy Code must be read in light of Congress's underlying goal of promoting healthy markets. In particular, when a lien-voiding rule—like Section 506(d)—helps give a debtor a fresh start, there is no reason to deviate from that rule where such deviation has little, or a negative, impact on the housing market. In such cases, any desire to deviate should yield to the Bankruptcy Code's general purpose of giving debtors a fresh start.

B. Protecting Junior Liens In Bankruptcy Does Not Promote Healthy Housing And Lending Markets

A prohibition on junior lien voiding interferes with healthy housing and lending markets. The Bankruptcy Code's general purpose of giving debtors a fresh start therefore applies in full force, and a deviation from Section 506(d)'s general command to void unsecured liens is unjustified.

Market analysis demonstrates that the Bankruptcy Code should distinguish between first and junior mortgages in the lien-voiding context. First mortgages help people purchase homes, and play a vital role in maintaining a healthy housing market. Junior mortgages, on the other hand, generally facilitate personal spending. As such, junior mortgages resemble personal debt and do not play a critical role in a healthy housing market. Moreover, junior mortgages that actually facilitated home purchases con-

tributed to *unhealthy* housing and lending markets in the lead-up to the 2008 financial crisis.

By portraying first mortgages and junior mortgages as differing only in priority, Petitioner ignores these market realities. Of course, first and junior mortgages do differ in priority; in the event of a foreclosure, the debt owed to the first mortgagee must be satisfied before any junior mortgagees can recover. *See Restatement (Third) of Property: Mortgages* §§ 7.1, 7.4 (1997). If the first mortgage is underwater—as Respondents' are in this case—then the second mortgage has no equity value. Priority, however, is not the only difference between first and junior mortgages. In today's marketplace, a first mortgage is a tool for gaining homeownership; a junior mortgage endangers it.

1. First Mortgages Help People Purchase Homes, Whereas Junior Mortgages Facilitate Personal Spending

First mortgages have long played a critical role in maintaining a healthy housing market. By allowing those who are not affluent to acquire a home through leverage, first mortgages have fueled investment in the housing market. And by allowing homeowners to enjoy the gains from rising home prices while paying down principal, first mortgages have contributed substantially to household wealth. The family home, bought with the help of a first mortgage, is a classic symbol of the "American Dream." Even after the financial crisis, homeownership and the mortgages that make them possible remain prevalent: in 2013, 65.2% of families owned their home, and 41.0% of families had a first mortgage. *Changes in U.S. Family Finances from 2010 to*

2013: Evidence from the Survey of Consumer Finances, Fed. Res. Bull., Sept. 2014, at 22, 34 n.44, available at http://www.federalreserve.gov/pubs/bulletin/2014/pdf/scf14.pdf. American families also have substantial wealth invested in their homes; the sum of the fair market values of all homes exceeds $20 trillion, securing $8.7 trillion in first mortgage debt (excluding first-lien home equity lines of credit, discussed below). Bd. of Governors, *Financial Accounts of the United States, Third Quarter 2014*, Fed. Res. Sys. 107, 117 (Dec. 11, 2014), available at http://www.federalreserve.gov/releases/z1/current/z1.pdf (hereinafter *Financial Accounts of the United States*).

Roughly 60% of first mortgages currently in existence were originated at the time of purchase; an additional 37% have been refinanced. *See American Housing Survey for the United States: 2011*, U.S. Census Bureau 79-80 (Sept. 2013), available at http://www.census.gov/content/dam/Census/programs-surveys/ahs/data/2011/h150-11.pdf (hereinafter *American Housing Survey*). Most of those who have refinanced their first mortgage—77%—did so in order to get a lower interest rate. *Id.* at 80. Only 14% have done so in order to obtain cash, *id.*, and in a healthy housing market, the actual value of equity converted to cash in these refinances is trivial. Indeed, while cash-out refinances became very popular in the mid-2000s, they do not play nearly as important a role today. According to Freddie Mac, homeowners who refinanced their first mortgage in the fourth quarter of 2014 cashed out only $6.7 billion—barely 0.06% of total home equity. Office of the Chief Economist, *2014 Fourth Quarter & Full Year Refinance Report*, Freddie Mac (Feb. 4, 2014), avail-

able at http://www.freddiemac.com/finance/pdf/RefiReport2014Q4.pdf; *Financial Accounts of the United States*, *supra*, at 117. The vast majority of refinanced first mortgages, then, as well as all first mortgages originated at the time of purchase, have the same basic purpose: to help people purchase and retain their homes.

Property law also recognizes the critical role of first mortgages in the housing market. Purchase-money mortgages (those used to purchase real property) usually have priority over all other liens, even those arising prior to the purchase. *See generally Restatement (Third) of Property: Mortgages* § 7.2 (collecting cases and statutes supporting this rule). Therefore, a mortgage that helps a family purchase a home will generally be defined as a first mortgage regardless of when it was actually originated. By the numbers and by legal definition, then, first mortgages primarily serve the purpose of promoting homeownership.

Junior mortgages, on the other hand, are taken out for purposes besides acquiring a home. Most junior mortgages are taken out to facilitate some form of personal spending: to consolidate debts (especially credit card debt, itself usually a vehicle for personal spending); to finance a child's college education; to pay for a large non-real estate purchase (e.g., a car, boat, or vacation); or simply to open up a line of credit and increase liquidity. Some junior mortgages also facilitate home improvement.

There are two common types of junior mortgages: open-end home equity lines of credit ("HELOCs"), which allow homeowners to borrow up to a certain credit limit against their equity, and closed-end,

lump-sum mortgages. A HELOC is a revolving line of credit that operates "much like a credit card," and usually funds a wide range of personal spending. *See Home Equity Loans and Credit Lines*, Fed. Trade Comm'n (Aug. 2012), available at http://www.consumer.ftc.gov/articles/0227-home-equity-loans-and-credit-lines. A 2007 Federal Reserve Board working paper collected data showing that about a third of HELOC funds are used for personal consumption (including "education, automobiles, medical and dental expenses, weddings, and vacations"); a third for consolidation of non-mortgage debt (often credit card debt); and a third for home improvement. Alan Greenspan & James Kennedy, *Sources and Uses of Equity Extracted from Homes* 40 (Fed. Reserve Bd. Fin. & Econ. Discussion Series, Working Paper No. 2007-20, 2007), available at http://www.federalreserve.gov/pubs/feds/2007/200720/200720pap.pdf. Few HELOCs are originated at the time of purchase; Respondent Edelmiro Toledo-Cardona's is no exception. Pet'r's Br. 5.

Classic home equity loans—garden variety closed-end junior mortgages—also usually fund personal spending. About half of the proceeds from home equity loans go to consolidation of non-mortgage debt, a quarter to home improvement, and a fifth to personal consumption. Greenspan & Kennedy, *supra*, at 8. These debt-consolidating, cash-out home equity loans essentially function like cash advances on credit cards. Like credit cards, then, HELOCs and home equity loans facilitate various forms of personal spending, and seldom fund home purchases.

The practice of taking out "piggyback" second mortgages in order to acquire property contributed to unhealthy housing and lending markets in the mid-2000s, but has since almost disappeared. In the lead-up to the 2008 financial crisis, many homeowners—including Respondent David Caulkett—were given piggyback second mortgages to cover what would otherwise be a down payment or a mortgage insurance premium.[2] These piggyback second mortgages increased loan-to-value ratios ("LTVs") while creating additional profits for the brokers and loan officers who sold them. As a consequence, the housing bubble grew. *See* Br. Amicus Curiae Adam J. Levitin Part I.A. And when the bubble burst, home prices plummeted, causing many second mortgages—including Respondents'—to become completely unsecured.

The role played by these piggyback mortgages was an historical aberration. The percentage of first mortgages burdened with a piggyback second mortgage rose from 2.1% in 2000 to 21.4% in 2006, but dropped back down to 3.5% in 2012. Andrew Leventis, *The Relationship Between Second Liens, First Mortgage Outcomes, and Borrower Credit: 1996-*

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[2] Traditionally, a home purchaser puts down 20% of the purchase price in a down payment. The LTV on a home with a 20% down payment is initially 80%. Making a 20% down payment ensures that the homeowner has some equity, at least initially, thus decreasing the risk of going underwater. *See* Dov Solomon & Odelia Minnes, *Non-Recourse, No Down Payment and the Mortgage Meltdown: Lessons from Undercapitalization*, 16 Fordham J. Corp. & Fin. L. 529, 541 (2011). Reflecting the greater risk of foreclosure on homes with high LTVs, homeowners who do not make a 20% down payment often must pay monthly mortgage insurance premiums. Leventis, *supra*, at 3.

2010, at 11 (Fed. Hous. Fin. Agency, Working Paper No. 14-3, 2014), available at http://www.fhfa.gov/PolicyProgramsResearch/Research/PaperDocuments/WP_14-3_Second_Liens.pdf. In 2013, as the housing market began to recover, financial institutions covered by the Home Mortgage Disclosure Act (HMDA), 12 U.S.C. §§ 2801-2810, reported $3.6 billion in junior mortgages originated for the purpose of home purchase, compared to $1.1 *trillion* in first mortgages for that purpose. *Home Mortgage Disclosure Act: Explore the Data*, Consumer Fin. Protection Board, available at http://www.consumerfinance.gov/hmda/explore (accessed Feb. 16, 2015). Generally, around 5% of HELOCs and 7% of closed-end junior mortgages facilitate the purchase of real property—including vacation homes and investment properties. Greenspan & Kennedy, *supra*, at 40. In a healthy housing market, therefore, piggyback second mortgages are a rarity. Second mortgages that are used to purchase a home, furthermore, contribute to an unhealthy housing market.

2. Junior Mortgages Provide A Peripheral Form Of Household Finance

Market data reflect the different roles of first and junior mortgages in a healthy housing market. The market share of first mortgages is substantially greater than that of junior mortgages: homeowners owe $8.7 trillion in outstanding first mortgage debt but less than one-twelfth of that—$680 billion—in outstanding junior mortgage debt. *Financial Accounts of the United States*, *supra*, at 107. Furthermore, 62% of American families have a regular first mortgage, while only 4.4% have a HELOC as a jun-

ior mortgage and 2.0% have a lump-sum junior mortgage. *American Housing Survey*, *supra*, at 75, A-33 (defining regular mortgages as all mortgages other than home equity and reverse mortgages). Overall, first mortgages are nearly ten times as common as junior mortgages, *id.*, and represent almost thirteen times as much debt.

In addition, first and junior mortgages are largely owned by different sectors of the economy and are serviced differently, as well. The vast majority—84.5%—of junior mortgages (including first-lien HELOCs) are held by U.S. banks.[3] *Financial Accounts of the United States*, *supra*, at 107. In our experience, these banks generally service their own junior mortgages. In stark contrast, U.S. banks own only 20.0% of first mortgages (other than first-lien HELOCs). *Id.* Banks often sell these mortgages to GSEs (i.e., Fannie Mae and Freddie Mac) and investors but maintain mortgage servicing rights. *See, e.g.*, *2013 Annual Report*, Bank of Am. Corp. 114, available at http://media.corporate-ir.net/media_files/IROL/71/71595/AR2013.pdf (describing mortgage servicing rights). GSEs own 49.9% of first mortgages, and back an additional 15.9% in mortgage pools.[4] *Financial Accounts of the United States*, *supra*, at 107. These holders of first mortgage debt pay dedicated servicing companies (sometimes divisions of banks) to manage their first mortgages.

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[3] Another 10.8% of junior mortgages are held by credit unions, and 4.6% are held by investors (including finance companies and holders of mortgage-backed securities). *Financial Accounts of the United States*, *supra*, at 107.

[4] Most of the remainder are held in asset-backed securities (7.7%) or by credit unions (3.2%). *Id.*

See, e.g., *2013 Annual Report*, *supra*, at 39 (reporting $550 billion of mortgage loans serviced by Bank of America on behalf of investors).

First mortgages, therefore, have a wide impact across economic sectors, while junior mortgages are largely the domain of banks. Protecting junior mortgages in bankruptcy would likely benefit Bank of America, whose home equity portfolio makes up 18% of its consumer portfolio, *id.* at 79, but Bank of America's incentives are not aligned with those of other players in the market. By contrast, first mortgages serve the core of the housing market; protecting first mortgages in bankruptcy therefore serves Congress's goal of maintaining a healthy housing market.

Because there is no good reason to extend special protections to junior mortgagees, the Bankruptcy Code should afford a debtor a fresh start by applying Section 506(d)'s general command to void unsecured liens. Junior mortgages ordinarily function as a peripheral form of household finance that, like credit cards, facilitates personal spending. When junior mortgages do facilitate home purchase, they contribute to unhealthy housing and lending markets. Thus, junior mortgages, unlike first mortgages, do not promote Congress's policy goal of maintaining a healthy housing market. Extending *Dewsnup v. Timm*, 502 U.S. 410 (1992), to completely unsecured junior mortgages would not serve the purposes of bankruptcy. Nor would it promote a healthy housing market. Instead, it would merely protect an unhealthy form of household finance.

3. *Several Loan Modification Programs Have Found It Prudent To Favor The Implementation Of First Mortgage Modifications, Rather Than Preserve The Rights Of Second Mortgagees*

The favorable treatment afforded first, as compared to second, mortgages under the federal Home Affordable Modification Program ("HAMP") reflects an implicit understanding of the different policy purposes these two types of loans fulfill. HAMP, implemented by the Department of the Treasury in 2009, along with its program designed specifically to deal with second mortgages (2MP), give junior mortgagees less control in the modification process than first mortgagees. *Treasury and HUD Announce Enhancements to Housing Program*, U.S. Dep't Treasury (Dec. 4, 2014), available at http://www.treasury.gov/press-center/press-releases/Pages/jl9714.aspx. Servicers of second mortgages that participate in 2MP are *required* to offer modifications to second mortgagors if they have already modified their first mortgage under HAMP These modifications are automatic, do not involve underwriting, and follow a strict set of guidelines. Also, second mortgage modifications under 2MP do not have to pass the HAMP "net present value test"[5] because it is assumed that any recovery through 2MP would be of greater value than foreclosure for an underwater second mortgage. *Making Home Affordable Program Handbook for Servicers of Non-GSE Mortgages*, U.S. Dep't Treasury 158-167 (Aug.

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[5] The net present value test determines whether the proposed modification would produce a greater return than a foreclosure for the loan's investor.

17, 2012), available at https://www.hmpadmin.com/portal/programs/docs/hamp_servicer/mhahandbook_44.pdf (hereinafter *MHA Handbook*). 2MP servicers are required to re-subordinate junior liens in order to "facilitate the modification of a first lien under HAMP," notwithstanding the resulting loss of security relative to the property's fair market value. *MHA Handbook*, *supra*, at 170. Under HAMP, the goal of arriving at a modification beneficial to first mortgagees and homeowners is prioritized over the interests of second mortgagees.

The 2012 settlements Petitioner and four other large mortgage servicers reached with the federal government and the Attorneys General of forty-nine states reflect the same understanding: second mortgages do not serve an essential function in healthy housing markets. Servicers receive substantially more credit towards their settlement obligations for modifying and forgiving first mortgage debt than second mortgage debt. For example, the consent judgment for the Petitioner provides "one-to-one" credit for principal reductions on underwater first mortgages, whereas for performing second mortgages, it provides only $0.90 credit for every dollar in write-downs. For principal reductions on seriously delinquent second liens (90 to 179 days delinquent) the judgment provides only $0.50 credit on the dollar. Consent Judgment, *United States v. Bank of Am. Corp., et al.*, No. 12–0361, at D-4, D-5 (D.D.C. Apr. 4, 2012). One reason the judgment provides credit for extinguishing second liens at all is to "support the future ability of the individuals to become homeowners." *Id.* at D-6. By crediting less to second lienholders for modifications, the settlements reaffirm the

fact that government actors value them less than first mortgages.

II. Junior Mortgages Interfere With Efficient Resolutions Of Troubled Mortgages, Harming First Mortgagees And Discouraging Purchase-Money Residential Lending

When a homeowner becomes financially distressed, the distinctions between first and second mortgagees become even more crucial. Without a means of voiding junior liens, entirely underwater second mortgagees can exert their hostage power to prevent economically efficient bargains, harming first mortgagees and the housing market. This undermines federal policy in three ways. First, it frustrates a central purpose of bankruptcy by allowing an out-of-the-money junior mortgagee to hold up a resolution that would maximize recovery for creditors as a whole, instead encouraging value-destroying foreclosures. Second, this destruction of value hurts senior mortgagees and therefore undermines federal policies that aim to provide a healthy and functional housing market. Finally, the ban on voiding underwater second mortgage liens threatens the fresh start that bankruptcy offers to the debtor, and is detrimental to surrounding communities, municipalities, and society at large.

A. Second Mortgagees Create A Hold-Up Problem By Hindering Economically Efficient Short Sales And Deeds-In-Lieu

A central lesson of the recent housing crisis is that voluntary mortgage modifications and short sales are often better ways for a mortgagee to realize value than enforcing its rights to the underlying col-

lateral under state law—particularly when a property is over-leveraged. *See* Cong. Oversight Panel, *Foreclosure Crisis: Working Toward a Solution, March Oversight Report* 6 (2009) ("When compared with the costs of foreclosure, the cost of loan workouts can often provide a more efficient, economically rational outcome for both the borrower and the lender."). Unfortunately, the presence of a fully underwater junior mortgage frequently hinders or prevents such economically efficient resolutions. *See, e.g.*, Christopher Mayer et al., *A New Proposal for Loan Modifications*, 26 Yale J. on Reg. 417, 419 (2009) ("[S]econd liens can be a barrier to successful modifications of first mortgages.").

Underwater junior mortgages not only hinder the loan modification process, as illustrated in Respondents' brief, but also frequently prevent workouts seeking to transfer ownership of the property and avoid the foreclosure process where loan modification and home retention are not possible or desirable. Where, as in the present case, the homeowner has no equity in the property, borrowers and first mortgagees often seek to resolve the defaulted loan and avoid a value-destroying foreclosure through one of two methods. First, they may attempt a short sale, in which the first mortgagee agrees to accept a reduced payoff of the debt (among other financial considerations) in return for the homeowner selling the property through the open market. *See, e.g.*, 24 C.F.R. § 203.370 (providing guidelines for short sales on Federal Housing Administration ("FHA") mortgages). Second, they may negotiate a deed-in-lieu, in which the borrower voluntarily transfers title to the mortgagee in exchange for financial considerations, typically waiver of any defi-

ciency between the value of the property and the total debt owed. *See, e.g.*, 24 C.F.R. § 203.357 (providing for conveyance by deed-in-lieu for FHA mortgages).

First mortgage investors in such situations stand to recover significantly more through these workouts than they would in the event of a foreclosure. A short sale maximizes the proceeds realized by the lender by allowing the house to be sold at or close to fair market value, rather than at the significantly discounted price it would receive in a foreclosure. *See* John Y. Campbell et al., *Forced Sales and House Prices* 3 (Nat'l Bureau of Econ. Research, Working Paper No. 14866, 2009), available at http://www.nber.org/papers/w14866.pdf (finding that foreclosures result in an average discount of 28% relative to fair market value). Likewise, a deed-in-lieu allows the mortgagee to acquire the home without incurring the expenses associated with a foreclosure.

Although these options preserve value for the first mortgagees, they can be blocked by a junior mortgagee whose lien must be released in order to effectuate the transfer. Vicki Been et al., *Essay: Sticky Seconds—the Problems Second Liens Pose to the Resolution of Distressed Mortgages*, 9 N.Y.U. J. L. & Bus. 71, 84 (2012). This is so even though the fully underwater second mortgagee would recover nothing in the event of a foreclosure of an underwater property, because no excess proceeds would be available to distribute to junior lienholders. Therefore, the costs of a failure to reach a deal are imposed on the first mortgagee in the form of (1) the discounted sales price discussed above and (2) the costs

of the foreclosure. Since a large proportion of both the costs and benefits of negotiating a more efficient alternative to foreclosure accrue to other stakeholders, junior mortgagees are less likely to invest in negotiating alternatives, resulting in inefficient foreclosures. *Id.* at 97.

When junior mortgagees do cooperate with a short sale or deed-in-lieu, they generally condition their cooperation on an extortion-like payoff of thousands of dollars from the parties, a cost typically shouldered by the first mortgagee. *See, e.g.*, Sumit Agarwal et al., *Second Liens and the Holdup Problem in First Mortgage Renegotiation* 5 (Fisher Coll. of Bus., Working Paper No. 2014-02, 2014), available at http://papers.ssrn.com/sol3/papers.cfm?abstract_id=2022501 ("Second lien owners have an incentive to 'hold up' any resolution (modification or liquidation) of the mortgage unless they can recover some price above the true value of their claim."). Our organizations have seen second mortgagees demand and receive payoffs of several thousand dollars to cooperate with a short sale. In fact, such demands are so common that regulators have had to account for them when designing short sale programs. For example, when the Federal Housing Finance Agency ("FHFA") announced a new short sale program for Fannie Mae and Freddie Mac in 2012, it provided for payments of up to $6,000 to second lien holders, explaining that "[p]reviously, second lien holders could slow down the short sale process by negotiating for higher amounts." *FHFA Announces New Standard Short Sale Guidelines for Fannie Mae and Freddie Mac*, Fed. Hous. Fin. Agency (Aug. 21, 2012), available at http://www.fhfa.gov/Media/PublicAffairs/Pages/FHFA-Announces-New-Standard-Short-Sale-Guidelines-

for-Fannie-Mae-and-Freddie-Mac.aspx. Whether by preventing a short sale or demanding a payoff, the junior mortgagee creates an economic loss for the first mortgage investors, despite the latter's senior lien position.

Furthermore, because of the transaction costs involved, underwater seconds are actually much more deeply underwater than may appear using standard valuation methods. Given the standard realtor commission of 6%, typically paid by the homeowner, and the other transaction and moving expenses incurred by such sellers, even a homeowner with "theoretical" equity on paper often will be underwater in fact. *See* Adam J. Levitin & Susan M. Wachter, *Second-Liens and the Leverage Option* 6 (U. of Penn. Inst. for Law & Econ., Research Paper, 2015), available at http://ssrn.com/abstract=2556687. If the transaction costs are, conservatively, 9% of the total price, the sale of a property with a fair market value of $100,000 will net just $91,000. If the homeowner had both a first mortgage for $95,000 and a second for $20,000, the second mortgage that seemed to be just partially underwater is in fact fully underwater once the transaction costs of the sale are accounted for. In a foreclosure, the transaction costs reduce the liquidated value even more significantly, as explained above. Thus existing law under *Dewsnup* already over-protects second mortgage creditors by including in its ambit second mortgages which are partially underwater on paper, but are, in fact, fully underwater. *Dewsnup* should not be extended further to include second mortgages that are wholly underwater.

B. The Bankruptcy Code Is Designed To Solve This Hold-Up Problem For The Benefit Of Creditors And Other Stakeholders

When a second mortgage is fully underwater, the hold-up value will generally be the only value the second mortgage retains. *See id.* at 18. Since bankruptcy is fundamentally designed to eliminate such hold-up problems, this value is not one that the bankruptcy process protects. Rather, bankruptcy is designed to distribute any available assets based on the relative priorities of the creditors as they are frozen at the time of filing. Holdups by effectively unsecured creditors contravene this purpose by allowing a creditor in a junior position to either extract value from a more senior creditor, or force an economically inefficient foreclosure that destroys the value of the underlying asset.

Since this loss is primarily borne by the first mortgagee, it also undermines Congress's policy goal of promoting a healthy housing market. The imposition of these costs makes the purchase-money lender's investment less certain, and therefore less attractive. Since junior mortgages are not essential components of a housing market that enables homeownership, protecting them from lien voiding at the expense of first mortgagees frustrates fundamental policy goals and is likely to lead to lower homeownership rates.

In addition to the negative impact on first mortgage investors, forcing distressed mortgages to be resolved through the foreclosure process rather than through voluntary mechanisms also is detrimental to homeowners, surrounding communities, and society

as a whole. For homeowners, prohibiting lien voiding on fully underwater junior mortgages threatens their opportunity for a fresh start through bankruptcy. In roughly half of the states that utilize judicial foreclosure, the foreclosure process requires the expenditure of public resources to support the increased demands on the court system. *See* The Washington Economics Group, Inc., *The Economic Impacts of Delays in Civil Trials in Florida State Courts Due to Underfunding* (2009) (finding that insufficient funding of the judicial system led to backlog of foreclosure cases at a cost of $9.9 billion to Florida citizens). Foreclosures have been widely documented to have a negative impact on the property values of surrounding properties. *See, e.g.*, Zhenguo Lin et al., *Spillover Effects of Foreclosures on Neighborhood Property Values*, 38 J. Real Estate Fin. & Econ. 387 (2009) (documenting a statistically significant diminution of property value within a 10 block radius and lasting five years from the date of foreclosure). Foreclosures also have significant adverse budgetary impacts on local governments, which suffer a loss of property tax revenue while simultaneously dealing with an increased need for municipal services. *See, e.g.*, G. Thomas Kingsley, Robin Smith & David Price, The Urban Inst., *The Impacts of Foreclosures on Families and Communities* 18 (2009).

C. The Connecticut General Assembly Has Recognized, But Not Fully Solved, This Problem

Recent Connecticut legislation, An Act Concerning an Optional Method of Foreclosure, Public Act 14-84 (the "Act"), acknowledges the problems posed

by junior lienholders and seeks to facilitate economically beneficial outcomes by creating a way to pass over second mortgagees' holdout rights. Conn. Pub. Act No. 14-84 (2014). The Act, which took effect on January 1, 2015 (pursuant to the subsequent Public Act 14-217), provides "foreclosure by market sale" as an alternative method for carrying out foreclosures. Both houses of the Connecticut General Assembly, understanding the threat second mortgages pose to restoring a healthy housing market, passed the bill unanimously. Under the Act, homeowners and first mortgagees can agree to short sell an underwater property without obtaining consent from junior lienholders. *See Testimony of Scott J. Sandler, Esq. Concerning Raised Bill No. 5514* (Mar 11, 2014) (statement of Scott J. Sandler) (noting that the Act "essentially permits a short sale to take place without any input from or approval of junior lien holders").

The Act allows for second mortgagees to maintain their interests in the property, but only upon their own initiative and at the expense of paying the full cost of the property, regardless of how much the borrower already owes the second mortgagee. Thus the short sale process can no longer be brought to a standstill in Connecticut by junior lienholders. Having a buyer in place before foreclosure is complete also allows the property to be sold at a higher price than at foreclosure auctions. *See Testimony Before The Banks Committee of the Connecticut General Assembly* (Mar. 11, 2014) (statement of Martin J. Geitz).[6] The Act effectively prioritizes securing an

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[6] Mr. Geitz testified that the Act "creates a 'pre-foreclosure' sales solution that will provide homeowners with no equity in

economically beneficial outcome for senior mortgagees over the right of an unsecured junior lienholder to slow down or otherwise obstruct the process.

While the Connecticut legislation demonstrates the need for effective mechanisms to address the difficulties posed by underwater second mortgages, it does not solve the problem. First, it cannot address these concerns in the other forty-nine states. Second, it only resolves the second mortgage hold-up problem in the context of short sales, and cannot address the problems second mortgagees pose to homeowners who seek to retain their homes through modifications or refinances. Thus, enforcing the lien voiding required by 506(d) in bankruptcy remains an important tool in renegotiating mortgages throughout the country.

III. A Ruling For Respondent Will Not Open The Floodgates To Lien Voiding

A. Borrowers Will Still Be Reluctant To Utilize Bankruptcy As An Alternative To Foreclosure

While junior lien voiding in bankruptcy would provide borrowers with greater bargaining power, utilizing such an alternative to foreclosure would still be costly and difficult for the borrower. By threatening to turn to bankruptcy to have the junior lien voided, borrowers could more effectively prevent

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their properties the ability to quickly and efficiently sell their properties without the stigma of foreclosure . It also has the potential to produce better sales prices for homeowners using this new approach." *Testimony Before The Banks Committee of the Connecticut General Assembly*, *supra*.

junior lienholders from impeding first mortgage modifications. *See* Part II, *supra*; *see also* Christopher J. Mayer et al., *Mortgage Modification and Strategic Behavior: Evidence from a Legal Settlement with Countrywide* (Nat'l Bureau of Econ. Research, Working Paper No. 17065, 2011), available at http://www.nber.org/papers/w17065 (discussing an example of borrower strategic behavior). Yet the costs of bankruptcy make it difficult for the borrower to use filing as a credible threat to lenders. The longer-term adverse effects of bankruptcy make it a less attractive alternative to foreclosure, and many individuals view bankruptcy as a last resort, rather than a platform for opportunistic behavior.

Despite the benefits of starting afresh, the process of filing for bankruptcy greatly encumbers debtors. Since the Bankruptcy Abuse Prevention and Consumer Protection Act of 2005 ("BAPCPA"), Pub. L. 109-8, 119 Stat. 23, the requirements for Chapter 7 bankruptcy filings have become more stringent. BAPCPA implemented a means test to keep "can-pay" debtors from abusing the benefits of bankruptcy. *See, e.g.*, Marianne B. Culhane & Michaela M. White, *Catching Can-Pay Debtors: Is the Means Test the Only Way?*, 13 Am. Bankr. Inst. L. Rev. 665 (2005). Additionally, the debtor must now produce a wider variety of documents for review. *See, e.g.*, 11 U.S.C. §§ 521(a)(1)(B)(iv), 521(f). Many of the new requirements necessitate legal counsel and the burden falls to the debtor to pay the resulting fees. *See* James J. White, *Abuse Prevention 2005*, 71 Mo. L.

Rev. 863 (2006). The result of BAPCPA has been to keep potential claims out of bankruptcy court.[7]

Not only is filing for bankruptcy a difficult process, bankruptcy has pervasive and lingering negative effects on the filer. A personal bankruptcy flag on a credit report substantially lowers an individual's creditworthiness. David K. Musto, *What Happens When Information Leaves a Market? Evidence from Postbankruptcy Consumers, Journal of Business*, 77 J. Bus. 725 (2004). Given the ubiquitous use of credit scores in today's financial markets (let alone employment, rental and insurance markets), any lowering of an individual's credit score causes significant negative repercussions by reducing the availability of future credit. Satyajit Chatterjee, et al., *A Theory of Credit Scoring and Competitive Pricing of Default Risk* (Apr. 2011) (unpublished paper) (on file with the University of Minnesota). Many homeowners who seek assistance from CFHC are reluctant to pursue bankruptcy even if it is an economically beneficial choice. This has largely to do with the nega-

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[7] See also Robert M. Lawless, et al., *Did Bankruptcy Reform Fail? An Empirical Study of Consumer Debtors*, 82 Am. Bankr. L.J. 349 (2008). Sen. Elizabeth Warren and Professor Robert Lawless argue that even as financial stresses intensify for consumers, bankruptcy filings have not increased accordingly. They estimate that in the years immediately after the implementation of BAPCPA, 800,000 families were discouraged from filing bankruptcy by its procedural changes. *Id.* at 375. Bankruptcy filings spiked in the immediate aftermath of the 2008 financial crisis, but have since fallen to pre-2008 levels. *Bankruptcy Filings Drop Nearly 13 Percent in Calendar Year 2014*, U.S. Courts (Jan. 28, 2015), http://news.uscourts.gov/bankruptcy-filings-drop-nearly-13-percent-calendar-year-2014.

tive connotations some homeowners have regarding bankruptcy and the variety of negative consequences that flow from filing for bankruptcy, discussed *supra*. Based on our experience, even if the Eleventh Circuit's judgments are affirmed, many individuals with underwater second liens would still refuse to file bankruptcy.

B. Wholly Underwater Second Liens Are Uncommon; Thus, A Ruling In Favor Of Respondent Is Unlikely To Cause A Substantial Surge In Lien Voiding

In the experience of CFHC, few homeowners seeking foreclosure assistance in recent years were burdened by completely underwater second mortgages. Out of a random sample of 177 homeowners for whom CFHC conducted a foreclosure prevention intake in 2013 and 2014, only 21, or less than 12%, reported having second mortgages that were completely underwater. This figure may also be higher than the proportion of underwater second mortgages nationwide because CFHC services four cities in the top one hundred cities with the highest negative equity in the country (including Hartford, Connecticut, the most underwater city in the nation, with a negative equity rate of 56%). Haas Inst., *Underwater America*, U.C. Berkeley (2014). Even while working in a region with high negative equity, CFHC has not observed a large percentage of wholly underwater second liens. Because financially distressed homeowners only occasionally have wholly underwater second liens, any effect from the Court's affirmance of the Eleventh Circuit's decision is likely to be minimal.

CONCLUSION

For the foregoing reasons, the judgment of the court of appeals should be affirmed.

Respectfully submitted.

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FEBRUARY 24, 2015